

1. Exchange rate policy has been increasingly accepted as of central importance for long-term development strategy and for creating an enabling environment for recovery and growth. The exclusive identification of exchange rate policies with stabilization or balance of payments management is giving way to its use as a major development policy. This is particularly critical in Africa for internal issues of development, galvanizing producing sectors, creating employment opportunities, modifying technologies, changing import-intensive consumption patterns, diversifying exports and promoting African self-reliance and integration. There is no alternative instrument of economic policy that has a comparably pervasive effect on all other economic decisions.

2. Hence orthodox Structural Adjustment Programmes (SAPs) or Economic Recovery Programmes (ERPs) embody an active exchange rate policy as a major component of their policy reforms. But exchange rate policy is typically addressed to the elimination of balance of payments deficits and is generalized export promotion. It embraces three basic elements: currency devaluation, floating exchange rate and foreign exchange auction in some AAF-SAPs. These measures are based on the operation of free market forces and the assumption of perfect competition with free mobility of resources.

3. But unfortunately, these exchange rate policies have not succeeded in achieving balance of payments viability and helping to reverse the African crisis. The resulting widespread dissatisfaction and frustration with the orthodox adjustment programmes and their policy instruments has prompted the elaboration of alternative policy instruments for managing Africa's recovery and transformation. In the African Alternative Framework to Structural Adjustment Programmes for Economic Recovery and Transformation (AAF-SAP), one of these recommended policy instruments is the multiple exchange rate system (MERS). As stated in AAF-SAP, this involves "utilizing the existence of *de facto* multiple exchange rate systems in a rationalized manner and/or creating and streamlining such a system for purposes of resource transfers, resource mobilization and reversal of capital flight and ensuring availability of essential imports". This should also include the "allocation of an increasing share of foreign exchange for imports of vital inputs for agriculture and manufacturing sectors".

4. Conversely, AAF-SAP indicates some exchange rate policies to avoid because they are inconsistent with African recovery and

¹ See AAF-SAP, p.40, Table 5.2 item A.9 and p. 39 item A.3.

² Ibid, pp. 37-8, Table 5.1.

transformation. These are generalized devaluation through open foreign exchange markets, currency auctions and large and frequent currency devaluations as well as "excessive dependence on market forces for getting the "prices right" in structurally distorted and imperfect market situations".

5. The attempt to use exchange rate policy in Africa to achieve parity with, or to eliminate, the parallel foreign exchange market is 'chasing the tail' or running after a shadow. This is because the operations of the parallel exchange market are governed by complex socio-economic factors, many of which do not respond to price signals. Such factors include the extreme scarcity of foreign exchange relative to its almost infinite demand; desire to avoid tax by not purchasing foreign exchange legally in order not to reveal income level; need to hide the recalcitrant sources of some of the earnings used in parallel foreign exchange transactions; fear of armed robbers in open financial transactions, etc. For these reasons, it is not true that the parallel market exchange rate measures the true marginal cost of foreign exchange which its official price must capture.

6. It is for these reasons that "the issue of the importance of exchange rate policy and the form it should take is no longer an ideological matter. It has been reduced to a pragmatic matter of what will work most effectively in given countries and circumstances".

7. The theoretical and empirical grounds for these positions on foreign exchange policy in the African context are discussed below together with the feasibility of MERS and the modality for its practical application in African countries.

II. Unified Exchange Rate Regimes and Generalized Devaluation

8. The attractiveness of the multiple exchange rate system (MERS) derives partly from the nature and disadvantages of unified exchange rate regimes and generalized devaluation. The unified exchange rate regimes are the floating, free or flexible and the fixed or crawling peg exchange rate systems.

9. Floating exchange rate system - Though the floating exchange rate system may be a single or multiple system, it is commonly used as a unified system. In some African countries, this floating system is operated through foreign exchange auction on weekly, daily or other basis. Under a flexible exchange rate regime, free market forces of supply and demand determine the level of exchange rate. The main advantage of the system is that its open market determination insulates the domestic economy from changes in external reserves, so that loss of reserves does not necessitate domestic deflationary pressures. The depreciation and appreciation of the flexible exchange rate are the means of equilibrating the balance of payments.

10. This, however, implies a preference for speculators rather than government or the Central Bank to regulate the external

balance. The other disadvantages of the flexible exchange rate system are that it raises the cost of foreign exchange; its depreciation increases the local currency cost of imports and domestic production; and as the inflationary pressure recedes on the exchange rate, any resultant demand for primary exports means that some of the advantages of the floating exchange rate system are lost. Moreover, a free exchange rate may require a larger fiscal outlay, and its operation tends to shift inputs to import-competing and export industries, regardless of domestic costs and priority requirements such as food. It is because of these disadvantages that developing countries that operate the floating exchange rate system do experience severe economic difficulties and abandon it. Thus Brazil's last exchange liberalization during 1965/72 was stopped because it led to very low rate of economic growth, and Uruguay's free exchange rate practices from 1961 and 1987 with the new peso were abandoned because of their inflationary effects. In Egypt, exchange liberalization during 1973/81 led to 75 per cent depreciation of the exchange rate. Zaire's longest experiment with the flexible rate system in sub-Saharan Africa from around September 1983 contributed much to severe balance of payments pressure and other economic problems that led to devaluation in 1985. The use of foreign exchange auction to achieve currency float also tends to divert scarce foreign exchange to speculative activities and excessive imports while facilitating capital flight.

Fixed exchange rate system

11. The fixed or crawling peg exchange rate system may also be single or multiple. It is commonly used as a single system and has the special advantage of ensuring stable currency values which encourage trade flows and investment, like the par value system under the gold exchange standard. Balance of payments deficits are corrected through the use of trade controls and external borrowing.

12. The major disadvantage of the fixed exchange rate system, however, is that it forces the domestic economy to adjust to the requirements of the balance of payments. So when there is a balance of payments deficit, controls have to be imposed that may hurt foreign trade and investment, thus generating deflationary pressure in the economy. Fixed exchange rates also tend to be over-valued and this retards exports and encourages excessive imports. This over-valuation of the exchange rate and protection of the domestic market through trade controls are major reasons for economic stagnation and capital outflow due to falling reserves under the fixed exchange rate system. The over-valuation of the fixed exchange rate often calls for generalized devaluation with its negative effects.

13. On account of these disadvantages, countries that practise the fixed exchange rate system tend to use the crawling peg with devaluation, or change to a multiple rate system. Thus Chile had a crawling peg rate during 1970/82 with a foreign exchange

of causing or fuelling inflation by raising the relative prices of traded to non-traded goods.

17. Tables 1a and 1b depict the massive and persistent generalized devaluation in selected African countries together with the associated high rates of inflation. The massive devaluations in the 1980s are indicated through the sharp reductions in exchange rates for the sample countries, with the exception of the last six countries in the table that resisted devaluation (the last five countries are among francophone members of the CEA zone whose currency is tied to the French franc). The least amount of *de facto* devaluation over the eight-year period in the table is about 300 per cent for Sudan, while countries like Ghana, Zaire, Uganda and Somalia have over 900 per cent.

18. Table 1b shows the correlation between these massive devaluations and pernicious inflation. Thus the average annual rate of inflation in the eight countries that devalued massively ranges from a minimum of 20.8 per cent to a maximum of 113.9 per cent, whereas the last six countries in the table that did not devalue had fairly stable price levels with moderate rates of inflation that range from a minimum annual average of 4.3 per cent to a maximum of 9.7 per cent. Generalized devaluation thus emerges clearly from the two tables as the most important single source of inflationary pressure in African countries in the 1980s.

Table 1a
Selected levels of exchange rate, 1982/89

Country	1982	1986	1988	1989 1st quarter
Ghana (cedi, c)	2.75	36.01	229.89	261.72
Nigeria (Naira, N)	6.670	3.316	5.353	7.5873
Uganda (shilling, US\$)	1.06	14.00	165.00	200.00
Sierra Leone (Leone)	1.23	35.587	39.062	14.052
Somalia (Shilling, Sh)	15.21	90.50	270.00	340.00
Sudan (Pound)	1.30	2.50	4.50	4.50
Zaire (Zaire, Z)	5.746	14.10	274.00	341.00
Zambia (Kwacha, K)	0.929	42.706	10.00	10.362
Ethiopia (Birr, br)	2.07	21.07	2.07	2.07
Senegal (CFA)	336.25	322.75	302.95	319.73
Cameroon (CFA)	336.25	322.75	302.95	319.73
Cote d'Ivoire (CFA)	336.25	322.75	302.95	319.73
Congo (CFA)	336.25	322.75	302.95	319.73
Central African Republic (CFA)	336.25	322.75	302.95	319.73

Note: These are average market exchange rates (incl.

Source: IMF, *International Financial Statistics*, vol. XLII, no. 12, December 1989.

19. Besides its pernicious inflationary effect, the theoretical conditions for devaluation to improve the trade

balance are typically not satisfied in African countries. Thus the classical Marshall-Lerner elasticity condition that requires the sum of the export and import elasticities of demand to exceed unity is not satisfied because of the very strong demand for imported necessities and low foreign demand for exports. Thus with relatively inelastic demand for their exports and imports, when these countries devalue, the demand for their exports and imports vary little. When their export demand is not restricted due to foreign protectionism and synthetic substitution, the long gestation period for increasing export production makes their export supply relatively inelastic and unable to benefit from devaluation in the short to medium-term. Agricultural exports are particularly prone to this supply rigidity. Moreover, in countries whose main exports are subject to quota at externally given prices, and with essential imports like petrol, drugs, capital goods, raw materials, spare parts, etc. devaluation produces a negligible effect on the balance of payments.

20. Generalized devaluation also raises the domestic cost of production and thereby decreases the competitiveness of local goods and services. The rising cost of domestic inputs also leads to capacity under-utilization. The change in relative prices that is supposed to switch demand from foreign to local goods after devaluation is also inhibited in African countries because of entrenched technical structures that do not permit much substitution of domestic for foreign inputs.

21. The assumption that devaluation can change the relation between wages and prices also disregards distributional equity that is affected by complex socio-economic factors. This is in addition to the fact that devaluation reduces the real value of given nominal wages. For agricultural producers also, even where devaluation increases nominal producer prices in local currency, these are often gobbled up by the even higher rate of inflation unleashed by the change in the relative prices of tradable to non-tradable goods. Such increases in the domestic price level also reduce the real value of private sector liquidity unless it is offset by commensurate changes in the domestic money supply.

22. Thus overall, as the internal effects of generalized devaluation tend to shift resources to import - competing and export industries, this stifles the domestic production of non-tradables. Hence on balance, devaluation leads to rising inflation, increased unemployment, capacity under-utilization, sharp increase in the cost of living, distorted income distribution, reduced rate of economic growth, the undermining of public sector investment and of development priorities.

III. Basis for Multiple Exchange Rate System and its Validity for African Countries

23. Multiple currency practices are designed to mitigate the disadvantages of the other exchange rate regimes and to promote the development process. Theoretically, the multiple exchange rate system (MERS) is based on the separability of international transactions into different markets or categories. Hence, in principle, an infinite set of multiple rates are applicable to different transactions.

24. For these reasons, we encounter MERS in major economic contexts, namely, development policy, balance of payments analysis, mechanisms of protection and tax analysis and the fiscal analysis of international transactions, such as export and import taxes and subsidies. Since the 1980s, however, multiple currency practices have arisen mainly in balance of payments analysis in connection with stabilization and adjustment programmes. In this context, multiple rates underscore the differences between monetary adjustment and development policy. These differences in turn emphasize two critical points.

25. One is that when the underlying causes of balance of payments deficits are real or structural as in African countries (and in the rest of the Third World), monetary adjustment through devaluation generalized as in orthodox adjustment programmes typically fails. This is because this type of mechanism, i.e. monetary adjustment, addresses only the surface manifestation of the problem and, at best, provides only temporary relief from the crisis, which tends to recur or to re-emerge. The real adjustment required to eliminate the structural causes of balance of payments disequilibrium cannot be addressed within this monetarist framework. The second point is that in most Third World countries, and particularly in Africa, MERS has been and continues to be used and advocated primarily in order to promote recovery and development. This is a much higher priority and larger pre-occupation in Africa and other developing regions than monetary or balance of payments stabilization. Indeed, in these countries, persistent monetary or payments imbalances are typical reflections of the underlying economic syndrome of underdevelopment. In these circumstances, the artificial restriction of MERS to monetary adjustment or the elimination of balance of payments is thus an untenable linear transfer of its function from the advanced countries to the developing regions. This depicts a gap in the literature on the treatment of these multiple rates in developing countries - just as the rest of the largely static and competitive neo-classical trade theory is seriously flawed and unsatisfactory in dealing with the reality in the developing countries.

26. In these developing regions, trade and development policy are intrinsically linked, so that trade and exchange policies are integral components of development policy. Monetary and balance of payments policies are also linked with development policy in that

external imbalance can be eliminated in the process of monetary adjustment only through simultaneous adjustment in the real economy. This requires resources re-allocation among sectors, for example, towards domestic import - substitution and selective export expansion. These are precisely some of the major objectives of the application of MERS in African and other developing countries.

Advantages and Possible Limitations of MERS

27. The advantages for MERS far outweigh the possible shortcomings. In particular, they combine the main advantages of the other exchange rate regimes and avoid their major disadvantages. Thus, these multiple rates are often adopted to avoid generalized and massive devaluation and its disruptive effects such as severe inflationary pressure. Hence any devaluation under the MERS is limited.

28. With unbearable external debt service obligations, African countries can drastically reduce their debt service payments in local currency. This is done by applying a favorable rate for debt servicing relative to other external transactions. Thus in Egypt during February 1988, its multiple exchange rate system allowed authorized banks to sell 10 per cent of their monthly foreign exchange receipts for external debt service. Zambia also used multiple rates to reduce the local currency cost of its external debt service.

29. In developing countries, MERS is also useful for promoting structural transformation in two main ways. One is through the diversification of domestic production structures which can take the forms of promoting import-substitution by granting protection to local industries, offering premium exchange rate that constitutes a subsidy to some activities and applying a penalty exchange rate to discourage others. For countries at early stages of industrialization, this is a very stimulating policy. Brazil used a MERS as a deliberate policy to stimulate national development in the post-war. Ecuador used it after 1922 to reverse its economic deterioration, and Egypt has been using it since 1981 to boost its industrialization and raise living standards. The other transformational use of MERS is for selective export promotion in strategic industries. When multiple rates have a free component, it gives the right incentives to export industries and encourages capital inflow that can be used to expand the export sector. This involves the application of a favorable exchange rate to such industries as a form of export subsidy or a kind of export rebate that reduces the production cost of such activities and raises their international competitiveness. Thus in the post-war era, Uruguay applied the most favorable rate of its multiple rate system for 'wool tops' in order to penetrate the international market for the product that had been dominated by European producers. After 1982, Ecuador also operated a MERS whose main objective was to re-establish the long-run competitiveness of the economy. Egypt

also used multiple rates to increase its manufactured exports during 1982/83 and 1983/84.

30. Import control is another major advantage of the use of MERS in many developing countries. In this context, the multiple rates are used as trade policy in the form of tariffs. A low exchange rate can thus be maintained for essential imports to keep their total cost low so that the depreciation of the domestic currency during adjustment does not affect the majority of the population with low income. A higher exchange rate is then applied to non-essential imports similar to a high tariff on them to reduce import demand. Such a MERS can also be used as an anti-dumping device against cheap imports that may ruin domestic infant industries or import substitutes. Argentina used such multiple rates with selective import taxes after 1987 to control imports, Paraguay had different effective exchange rates for different categories of international transactions for restricting imports after 1985, and Egypt did the same during 1980/86 when its current account deficit rose. Ghana used its parallel market rate for its special import licence scheme (SIL) from October 1985 to control imports, while Nigeria, Uganda and Zambia also used the dual exchange rate system to restrict imports.

31. The MERS also enjoys the advantage of promoting confidence in an economy and encouraging the inflow of workers' remittances. This is particularly the case where increased returns on holdings of local currency relative to foreign exchange are offered through changes in interest rates and the rate of inflation. This is the case of the use of differential interest rate policy (DIRP) to supplement a MERS. Egypt has used multiple rates very successfully in this way to attract huge workers' remittances from neighbouring oil producing countries. This was done in 1968 with an official rate of LE 0.34 to the US dollar and another rate of LE 0.58 per dollar, and again in 1981 and 1987. Other countries like Ghana used multiple rates to attract remittances and tourism, while Yaire used its own dual rates during 1983/84 to curb diamond smuggling.

32. The control of capital flight is another important advantage of MERS. When one of the multiple rates is relatively high, it discourages the repatriation of capital and encourages capital inflow. This is critical for African countries that have been suffering from massive export of capital, especially since the 1980s.

33. Finally, a MERS in the African context has the additional merit of being suited to the pervasive market imperfections in the region. This is so central to the validity of the competitive model that is used for designing exchange rate policy in African countries that it is treated separately below.

34. Like all economic policies, however, MERS has possible shortcomings. These are first, that under MERS, there may be fraudulent transactions across foreign exchange markets. This is

optimum. So while the search towards equilibrium may still be valid in African countries, this is clearly a long-term objective for which there is no transformation should not be sacrificed. Hence in the present state of underdevelopment in African countries, the search should not be for equilibrium as such, but for the most efficient way of managing disequilibrium in its effort to achieve long-run competitive viability.

38. Two examples will illustrate these competitive equilibrium problems in the foreign exchange markets of the African context. One is that during the seasonal pilgrimages, the demand for foreign exchange rises sharply for speculative purposes and falls thereafter, regardless of the legal exchange rate. The other is that since the collapse of the Ugandan airline, the demand for foreign exchange has fallen drastically and reduced the domestic value of the dollar without reference to the conventional market forces of demand and supply of export and imports.

39. In all such situations of 'market failure' and persistent disequilibrium associated with structural underdevelopment, a managed MERS is superior to the other exchange rate regimes discussed earlier. Past and current empirical applications of the MERS in such diverse countries as Brazil, Argentina, Chile, Ecuador, Paraguay and Uruguay in Latin America as well as in African countries like Egypt, Ghana, Madagascar, Nigeria, Somalia, Uganda, Zambia, Zaire and Zimbabwe (South Africa have demonstrated the validity of the MERS in African countries under imperfect markets. These past experience clearly justify a more multiple exchange rate system to avoid complications and then enforce the strict discipline and controls in order to ensure its effectiveness. In these ways they maintain effective checks against excessive foreign exchange transactions, and also prevent their inflow or outflow from becoming permanent. In this pragmatic way, countries have been able to overcome MERS to suit their peculiar circumstances.

Situations that warrant the use of MERS in Africa

40. Besides the advantages of MERS, SAP-IV (1977) lists some major motivations that warrant the use of MERS in the context of Africa. These were: (i) requirements of transformation; (ii) "encouragement of capital inflows, especially by nationals working abroad and discouragement of capital flight; (iii) improvement in balance of payments; (iv) satisfaction of critical needs." These situations cover the requirements of development strategy with regard to both monetary adjustment (i.e. balance of payments adjustment) and real adjustment. Thus the encouragement of capital inflow and the restriction of outflow is designed to generate a net inflow, which is critical for increasing the levels of aggregate investment and production as well as improving the balance of payments. The MERS is also

¹ SAP-SAP, pp.34-40, Table 5.1

useful for providing a low exchange rate for essential imports like drugs, spare parts, petrol, agricultural chemicals, etc. for meeting the critical needs of the population.

41. In addition, MERS has also been used and is useful in African countries for the protection of infant industries, export diversification through the promotion of specific exports and for the encouragement of industrialization. Thus from the 1960s when the post-war boom pitted out, multiple rates have been used extensively in developing countries as deliberate instruments for structural transformation. This is through the granting of implicit import and export subsidies to promote some basic industries with high growth potentials in order to accelerate the development process. Accordingly, the MERS is also useful for shutting out non-essential imports in order to conserve scarce foreign exchange for the import of critical capital goods, intermediate products and raw materials for the development process.

Types of MERS and their uses

42. The separability of international transactions that make MERS feasible points to two typologies. These are by (a) commodities and (b) types of transactions. The latter grouping is difficult to achieve but relevant.

(a) MERS for different groups of traded commodities and financial assets

43. The different sub-groups of commodities and financial assets are:

- (1) primary commodities and raw materials;
- (2) manufactured goods and services;
- (3) different types of investment and foreign exchange.

(b) MERS for different groups of traded commodities and services

44. The multiple rates for trading different groups of traded commodities and services are:

- (1) exchange spread or margin between buying and selling rates;
- (2) penalty exchange rate for some exports;
- (3) subsidy rate for some exports;
- (4) penalty rate for some imports;
- (5) subsidy rate for some imports.

Approaches to the use of MERS

45. These eight different MERS correspond to four common approaches to the use of multiple rates, namely, by

- (1) economic priorities, e.g., essential imports like drugs, capital goods, etc., debt servicing, export promotion, basic industries, etc.
- (2) dual exchange rates, e.g., official and non-official or commercial and financial exchange rates;
- (3) different import and export categories with a different exchange rate applying to each group of commodities;
- (4) a special margin related buying and selling exchange rate.

46. Out of all these different types and approaches to MERS, the commonest one that is used by most countries that practise multiple rates are the official and non-official or the commercial and financial exchange rates. These exchange rates have three attractive features. First, they are simple and avoid the cumbersome complexity of any rates that would have to be difficult to distinguish and adjust among different types of goods, services, and other transactions. Second, they do not usually apply to the capital account, except for debt servicing which is not part of normal capital flows. Third, these multiple rates can be so designed that some are fixed within a range or crawling pegs while others are allowed flexible rates so that the multiple rates enjoy the attractive advantages of both fixed and flexible exchange rates, while avoiding their major disadvantages.

Feasibility and Implementation of MERS in Africa

47. The empirical feasibility of MERS for African countries derives from the lessons of experience accumulated from its past and current practical application in various countries in Latin America and Africa. These experiences have indicated some basic similarities in underlying circumstances, practical design, implementation, requirements, and monitoring procedures in different countries.

Lessons of Empirical Experience with MERS

48. Several countries in Latin America and Africa have applied multiple exchange rates at various times and their empirical experiences provide important lessons for the use of MERS for recovery and transformation in Africa. These countries include Argentina, Brazil, Chile, Ecuador and others in Latin America as well as Egypt, Ghana, Nigeria, Uganda, Zambia, Zaire and apartheid South Africa among others.

49. In Latin America, the MERS or its equivalent has been used widely from the 1950s and it is still being used especially since the crisis of the 1980s. But the complex multiplicity of exchange rates practised in Brazil and other Southern countries of the

region have been abolished. The major reasons for the adoption of multiple rates in Latin America were because the use of official parity rates were inadequate for restricting import demand, while devaluation was seen as fuelling inflation, raising import cost and giving undue benefits to exporters. The conscious promotion of development and export diversification have also been additional reasons. Hence when many of these countries dismantled their multiple rate system, they imposed export taxes or retained exchange control. The most common problems or failure of the MERS in these countries have been : (a) the inclusion of most imports under the preferential exchange rates and few luxury items under the higher rates, so that such multiple rates were inadequate for suppressing excessive imports, and (b) the tendency to make the multiple rates more complex due to the pressure of exporters and importers to introduce new rates.

50. In African countries, multiple rates have been and are still used mainly for dealing with balance-of-payment deficits and debt servicing. The standard context has been short-term stabilization or structural adjustment. Hence the African experience with the MERS has tended to be for mainly monetary adjustment and over relatively short periods. Consequently, African countries have not used multiple rates widely so far for real adjustment or deliberate development policy and for longer periods as in Latin America hence the poor performance of their exchange rate policies so far. Moreover, whereas multiple currency practice in Latin American countries typically refers to two or more legal exchange rates, there is a tendency in defining dual exchange rates for African countries as involving an official rate and an illegal parallel market rate a usage that restricts the feasibility of the MERS in Africa.

51. Overall, the cases of successful application of multiple rates typically hinge on the satisfaction of some basic conditions. One of these is non-complex design especially where there are fixed and free rates. The provision of adequate time for real adjustment to occur is also essential when the multiple rates have developmental objectives. The use of complementary policies such as export incentives, exchange control and restrictions on imports is also critical. The avoidance of massive, frequent and generalized devaluations and other destabilising policies, the maintenance of effective discipline that includes foreign exchange allocation to priority uses and the eventual unification of multiple rates to a managed crawling peg exchange rate were also essential. Fiscal - monetary reforms with moderate budget deficits and deficit financing were also necessary.

52. Conversely, the cases of poor performance of MERS were those that involved the use of many complex rates, large deficit financing with high rates of inflation, frequent currency devaluation and official interference with the contents of the MERS. The multiple rates should also not become permanent sources of raising fiscal revenue. These are the negative practices that should be avoided in the application of the MERS which is,

therefore, inconsistent with many aspects of orthodox structural adjustment programmes such as import liberalization, large and frequent currency devaluation, high interest rates and generalized credit squeeze.

53. Countries in Special Situations - These lessons of experience with the use of MERS direct attention to African countries in two special situations. These are:

54. (a) Currency Union Countries - These are countries tied to major international currencies such as francophone countries in the CFA zone. Their national currency, the CFA, is tied to the French franc. This means that their use of MERS has to be arranged with the members of the currency union in order to ensure that changes in parity between the CFA and the French franc are acceptable to all concerned.

55. (b) Integrating countries - MERS poses no problems for economic integration that involves the removal of trade barriers, and for production integration to exploit economies of scale. Different kinds of multiple currency practices in some African countries are also compatible with financial integration. Thus if there is a payments or clearing arrangement among countries, their use of MERS will require them to use an agreed unit of account, e.g., a common treasurer's ledger as in PTA countries or an external currency like the SDR. Exporters of each commodity receive in their local currency, the amount established by the corresponding exchange rate, and importers will pay for the unit of account, the rates which the authorities will set for transactions. The clearing will then be among central banks in units of account which may be converted or not into other currencies, according to the agreement of the integrating countries.

56. When their MERS includes free market exchange rates for some transactions like capital movements or tourism, these can be settled in two possible ways. One is to leave such transactions out of the clearing arrangement or financial integration. Another is to channel such free market transactions through the clearing arrangement and realize them in the currencies agreed upon by the transactions. Thus in order to facilitate the settlement of multi-lateral payments when some of the members have MERS, all member countries should respect and reinforce the exchange regulations of all members in their states.

Implementation of MERS within AAE-SAP

57. In the context of AAE-SAP, the implementation of MERS requires the clear articulation of its objectives, the conditions for its effective use and practical implementation modalities.

(a) Objectives to be realized

58. The recovery and development objectives of AAF-SAP which can be pursued with MERS include regional food self-sufficiency; poverty alleviation through the promotion of agriculture; rural development and the satisfaction of critical needs like drugs; encouragement of capital inflows and restriction of outflows; achievement of self-sustained development through sectoral expansion, diversification of the production base, increased manufacturing and higher capacity utilization through essential imports; and improvement in the balance of payments.

(b) Conditions for effective use of MERS in AAF-SAP

59. The basic conditions for the effective use of MERS are the complete separability of markets through the elimination of fraudulent transactions across exchange markets due to the existence of a foreign exchange discount between the markets and the application of single multiple rates. The use of MERS with or without foreign exchange allocation, depending on its relative supply or the state of external reserves, also requires effective administrative control and enforcement to avoid foreign exchange speculation and corruption. There is also need to design relevant complementary policies such as differential interest rates and non-expansionary fiscal and monetary policy as well as trade integration that removes barriers to trade flows. The monitoring of the implementation of MERS is also important.

Modalities for Implementation of MERS

1. Administrative and institutional arrangements - These should consist of two main parts:

60. (a) Responsibility for implementation - This should be vested in the Central Bank with the effective participation of the allied Ministries of Finance, Planning and Trade. Their specific responsibilities for the design, implementation and enforcement of the rules and controls of MERS should be defined as clearly as possible at the highest possible level of executive authority:

61. (b) Monitoring Committee - This should be at the highest possible level and consist of officials of the Central Bank as well as the Ministries of Finance, Planning and Trade. Its functions should be the systematic monitoring of the actual implementation of MERS, so it should ensure the complete separation of foreign exchange transactions or markets in order to eliminate fraudulent transactions and corruption; enforcement of the discipline and controls of MERS through the imposition of binding sanctions against violations of the regulations of MERS in order to prevent official abuse; ensure the prompt correction of errors of design and implementation; and respond to unforeseen developments during the application of the multiple rates.

2. Combination of managed crawling peg rates with free rates - the crawl or band for the fixed rates is to avoid

steering the budget - the free exchange rates should adjust to independent forces that influence the balance of payments. The multiple rates should not apply to the capital account of the balance of payments. Trade exchange restrictions should be assigned to give as much stability as possible - this requires adopting MERS with other measures to stabilize the economy;

3. In moving from one exchange rate for all transactions to MERS with low rates for essential imports and higher rates for other transactions, transfer these other transactions (non-essential imports and capital inflows) to the new rates gradually;
4. Organize the free exchange rates through banks or exchange bureau in order to achieve their stability;
5. Integrate multiple rates with fiscal, monetary and price policies in a non-inflationary direction;
6. The MERS should be taken as a serious policy that requires a high level of administrative capability and discipline so that its controls can be maintained effectively;
7. Complementary measures are required in order to achieve the objectives of MERS, e.g., low rate of inflation, attractive interest rates, confidence in the domestic economy, increased capital inflow and foreign investment through economic stability;
8. Other reforms are essential, for example, of the production structure, food supply, changes in consumption habits and higher price elasticity of domestic demand for imports, all implying that MERS should effectively reduce the demand for money. Thus fiscal policy through well-studied and designed systems of taxes and subsidies can reduce the demand for money and change consumption habits;
9. Monetary measures such as selective credit policy, Differential Interest Rate Policy (DIRP) and the reduction of bank lending reserves in rural domestic production for development, reduce inflation and encourage the inflow of remittances;
10. All policy actions should act on both the supply and demand sides of the economy. Thus general export promotion may reduce supplies for domestic consumption unless it is done selectively with measures to increase production and allocative efficiency. This supply-side emphasis is critical because it is the orientation of SAP-SAP.
11. Apply related or complementary policies such as advance export deposit, payment conditions, export and import tariffs, subsidies and rebates that do not conflict with

MERS. These are alternatives to additional multiple exchange rates.

V. Policy Trade-offs and Complements to MERS

62. (a) Policy trade-offs with MERS - As the use of MERS involves a selective choice of development options, some other policies are trade-offs that tend to neutralize MERS and they should be avoided. These are:

(i) credit expansion - this is inflationary and weakens the effectiveness of MERS;

(ii) off-setting trade policies like tariffs, subsidies and rebates on exports and imports should be synchronized with MERS. For example, if a foreign transaction enjoys the lower of two multiple rates, this amounts to a subsidy on such a transaction and so the imposition of a tax or tariff on it will off-set the incentive given by the multiple rate;

(iii) sales taxes and domestic subsidies on imported goods subject to multiple rates can also cancel out the effects of the MERS. In all these cases, the differences between real and nominal effective exchange rates should be evaluated to avoid policy conflict.

63. (b) Policies Closely Related to MERS

(1) Advance import deposit - This policy is the same as exchange spread if the import deposit is large and sustained. It is a form of MERS or a monetary policy for increasing or contracting the monetary base for credit creation. The effect is once and for all unless the policy is changed. In Latin America, its objective has been to reduce the level, or change the structure, of imports so that it is an alternative to devaluation or direct MERS. Its shortcomings are that it constitutes a free loan by importers to financial institutions and it is inappropriate for capital and invisible transactions such as insurance, travel, etc.

(2) Payment Conditions - this policy package imposes restrictive conditions on international payments. The conditions are designed for restricting some imports, rationing foreign exchange and giving payment priority to essential imports such as machinery, plant and equipment, raw materials and spare parts. They are commonly used for barter or bilateral trade agreements and for partial or full devaluation. Common examples of payments conditions are delayed foreign exchange cover for some imports such as 180 - day grace before payment; five to eight year credit for 80 per cent of the value of imported capital goods like machinery; and advance payment by foreigners for exports of strategic products like uranium. These payment conditions and advance import deposit are temporary measures.

(c) Complementary policies to MEFS

64. As exchange rate policy, foreign exchange and the external sector tend to be exaggerated in African countries, these countries have to decide which policies to stabilize and which to adjust. Hence AAF-SAP identifies specific policies that should be used to complement MEFS. These are trade policies, differential interest rate policy (DIRP) and fiscal reform.

(1) Trade policies

(i) These involve the selective use of trade measures, including the banning of specified luxury imports, high tax rates on conspicuous consumption and on import of competitive inputs with domestic substitutes;

(ii) Specific export incentives such as tax rebates for processed exports and carefully selected primary export commodities;

(iii) Differential export subsidies, removal of trade barriers and encouraging barter trade to boost intra-African trade;

(iv) Bilateral and multilateral trade agreements on primary commodities.

(v) Advance import deposit and payment conditions as de facto alternatives to additional multiple rates.

(2) Differential interest rate policy (DIRP)

65. This involves :

(i) Sectoral allocation of credit with credit guidelines that favour the food sub-sector and the manufacture of essential products;

(ii) Use of selective nominal interest rates such that the interest rates on loans for speculative activities are higher than the rates on loans and advances for productive purposes, with the resulting weighted real interest rates for savings being positive;

(iii) Creation of a special fund for loans at subsidized interest rates to special economic groups.

66. (3) Fiscal - Monetary Reform - the fiscal and monetary reforms to supplement the MEFS should include the devotion of at least 20-25 per cent of total public investment from foreign exchange earnings or foreign loans to agriculture. Other fiscal

¹ See AAF-SAP, pp. 39-42.

reforms include the limitation of foreign debt service ratios to levels consistent with accelerating and sustainable development; enlarging the tax base and improving the efficiency and probity of tax collection; removal of subventions to parastatals except those in the social services sector and nationally strategic or basic industries; and use of selective subsidies, pricing policies and related measures to increase the supply of essential commodities for development. The associated monetary reforms involve monetary restraint with low rate of inflation and moderate interest rates through limited, realistic and decreasing rate of deficit financing for productive and infrastructural investments with low import content as well as the strengthening of intra-African monetary and financial co-operation with payments and clearing arrangements.

VI. Recommendations and Follow-up Action

Recommendations

67. On the basis of the above discussions, the following recommendations on MERS are pertinent for the successful operation of multiple rates in African countries in order to facilitate their accelerated recovery and transformation within the context of AAF-SAP:

1. Feasibility of MERS - African countries should apply an active exchange rate policy that involves the use of multiple rates or multiple currency practices within AAF-SAP for recovery and transformation. Such MERS should be supported by related policies like advance import deposit, payment conditions, differential interest rates, import-export taxes and subsidies where necessary.
2. Objectives of MERS - The basic objectives for using the MERS in African countries should be the acceleration of recovery and transformation through selective promotion of exports; diversification of production in favour of industrialization and the achievement of regional food self-sufficiency; the amelioration of the unbearable burden of external debt service; and the achievement of balance of payments viability.
3. Policy preparation - The adoption of MERS should be preceded or associated with basic economic reforms to create an enabling environment for it. Financial reform to eliminate large deficit financing and high inflation along with changes in import-biased consumption habits are critical here. Fiscal, monetary and price policies should move in the same direction and complement themselves.
4. Duration of MERS - As a recovery and development policy, the duration of the multiple currency practice will vary from country to country. Hence, its duration in each country should be a function of the achievement of its objectives.

5. Modality and structure - In order to minimize the administrative demands of the MERS, it should be as simple in design as possible. It should consist of a managed crawling fixed rate or rates that can be adjusted within a band for essential imports, and free rates determined by market forces through the banks or exchange bureau for other imports.
6. Treatment of parallel foreign exchange market - where an illegal or parallel exchange market exists, the MERS should not aim at eliminating it because this may be chasing a mirage. But the free legal rates of the multiple exchange system should be as close to the parallel rate as possible. This will reduce the premium in the parallel market. This requires that exporters should surrender their export earnings to the banking system so as not to use them to finance the parallel market.
7. Implementation machinery - The multiple rate system should be operated primarily by the Central Bank. The guidelines and regulations for it should be worked out jointly with the Ministries of Finance, Planning and Trade. There should be a clear division of responsibilities among these agencies in the operation of the system in order to ensure that controls and discipline are enforced effectively. So the Central Bank should be given full powers to impose sanctions against any violation of the regulations.
8. Monitoring committee - There should be a Monitoring Committee for MERS to be composed of officials of the Central Bank, Finance, Planning and Trade Ministries. Its functions should be as indicated above.
9. Related policies to MERS -
 - (a) Policies that are trade-offs against MERS and conflict with it such as neutralizing taxes and subsidies on exports and imports should be avoided;
 - (b) Complementary policies such as domestic taxes and subsidies, foreign exchange allocation to markets, fiscal and monetary restraint, differential interest rates as well as the inducement of capital inflow will facilitate the effectiveness of multiple rates. Some of them are like de facto MERS (e.g. export and import taxes and subsidies), while some like the reform of taxes and expenditure should precede MERS, and others like the restructuring of consumption and production should accompany it.

Follow-up Action for Implementation of MERS in Member States

68. This report provides general technical information on MERS as an AAF-SAP policy instrument. It has established a case for the use of multiple rates as part of a package of policies for accelerated recovery and transformation in Africa. The required follow-up action for its implementation in individual countries should involve three sequences.

69. (a) Detailed Country Feasibility Studies. - It is now necessary to move from the general to the specific by undertaking detailed study of the practical use of MERS in individual African countries. The detailed studies should be designed with a format that elicits the most critical information as suggested below, and such studies can be done by member states themselves or with the assistance of the ECA. The detailed study should focus on:

- (i) Review of existing and past exchange rate policies, especially in the 1980s;
- (ii) Financial history and profile of the country in the past decade;
- (iii) Role of exchange rate policy in the country's overall adjustment programme so far;
- (iv) The main objectives as well as possible costs and benefits of MERS in the country;
- (v) The specific administrative and institutional machinery needed for the implementation of the policy;
- (vi) The feasible multiple foreign exchange markets that can be separated and the possible levels of the exchange rates;
- (vii) Related policies to MERS to be avoided as trade-offs and those to be used as complementary policies as discussed above;
- (viii) Other matters relevant to MERS that are indicative of the special circumstances of the country, e.g., the possibility of relaxing currency zone membership in order to operate MERS.

70. (b) Collation of the detailed feasibility studies by the ECA. This provides more detailed lessons of experience and case-studies, offers opportunities to fill in gaps and modify options that may be proposed in the studies.

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